



**BILL LOCKYER**  
TREASURER  
STATE OF CALIFORNIA

March 5, 2008

Charles P. Valdes  
Chairman  
Investment Committee  
California Public Employees Retirement System  
400 "P" Street  
Sacramento, CA 95814

RE: Request to Add Agenda Item – Municipal Bond Rating Agencies

Dear Mr. Valdes:

I request that the Investment Committee at its March 17 meeting consider and act on a joint effort by municipal bond issuers and investors to convince the three leading rating agencies – Fitch, Moody's, and Standard & Poor's – to reform their methods for rating government-issued bonds as compared to corporate bonds. The attached letter to the rating agencies details how the current system unfairly treats municipal issuers and misleads investors about the risk of default. As the letter notes, the rating agencies' differential treatment of municipal issuers costs taxpayers billions of dollars in higher interest rates and largely unnecessary bond insurance payments.

The unfairness of the system is demonstrated by the fact that bonds issued by government entities, which almost never default, often receive lower ratings than bonds issued by corporations, which have much greater rates of default. Recent failures of highly-rated collateralized debt obligations, structured investment vehicles, as well as the turmoil in the bond insurance market, have highlighted problems related to the current rating system.

March 5, 2008  
Charles P. Valdes  
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I strongly believe public retirement systems have a substantial interest in ensuring the bond rating system is fair, accurate and sufficiently transparent to be well and widely understood. I request that the Committee and Board endorse this reform effort.

I and my staff will be glad to work with CalPERS staff to review the issues and craft the most appropriate recommendation for action by the Committee and the Board at the March meeting.

Thank you for your consideration of this matter.

Sincerely,

A handwritten signature in black ink that reads "Bill Lockyer". The signature is stylized with a large, looped "B" and a cursive "Lockyer".

BILL LOCKYER  
State Treasurer

Attachments:

Letter from State Treasurers and Municipal Finance Officers to  
Ratings Agencies  
Articles from New York Times and Bloomberg

cc: Members of the Investment Committee

Fred Buenrostro  
Russell Read  
Curtis Ishii  
Anne Stausboll



**BILL LOCKYER**  
**TREASURER**  
**STATE OF CALIFORNIA**

March 4, 2008

Mr. Michael Belsky  
Group Managing Director  
U.S. Public Finance  
Fitch Ratings  
70 W. Madison Street  
Chicago, IL 60602  
FAX: 312-422-6898

Ms. Gail Sussman  
Group Managing Director  
Public Finance  
Moody's Investors Service  
250 Greenwich Street  
New York, NY 10007  
FAX: 212-298-6846

Mr. William Montrone  
Head of U.S. Public Finance  
Department  
Standard & Poor's  
55 Water Street  
New York, NY 10041  
FAX: 212-438-2159

Dear Mr. Belsky, Ms. Sussman, and Mr. Montrone:

We, the undersigned representatives of major municipal bond issuers, urge the rating agencies you head to create new rating standards for U.S. municipal debt. For years, municipalities have been held to a higher standard than corporate issuers. This differential treatment undermines the functioning of an efficient and transparent capital market, a goal shared not just by investors and issuers, but rating agencies as well. For investors, the current system greatly inflates the risk of investing in municipal bonds relative to alternative investments, leading to investment decisions that are not based on the best information. For municipalities, the dual standard has cost our taxpayers and ratepayers billions of dollars in increased interest costs and bond insurance premiums.

Recent events in the debt markets have highlighted the problem. Many collateralized debt obligations (CDOs) and structured investment vehicles (SIVs) that your agencies rated triple-A have become insolvent or are at risk of insolvency. As a result, your agencies have been forced to downgrade those securities, as well as the ratings of some of the bond insurers who guaranteed them. Meanwhile, the vast majority of municipal issuers have not shown strains that would suggest they may default on their bonds. Nonetheless, many strong municipal issuers continue to carry much lower ratings than our corporate counterparts, in some cases even lower than the bond insurers about whom the market has understandable concerns. To illustrate this point, we note recent credit default swap levels for bond insurers with triple-A ratings have been many times higher than the levels for many of the biggest and most stable — but lower-rated — municipal issuers.

The ratings services your agencies have provided historically have been critical to the smooth functioning of the municipal bond market. Given the myriad state and local issuers of tax-

exempt debt, your agencies have served an important role in helping investors choose and price municipal bonds. That function will remain critical in the future. But we believe your rating scale bears too little relationship to most investors' paramount concern: the risk that issuers of the bonds they buy will default.

Across the country, for decades, the evidence has been clear and convincing. State and local governments almost never default on the bonds they issue. The safety of municipal bonds is grounded in a fundamental fact: a city or a state simply is not going to go out of business during the life of its bond issue. That possibility is much more likely in the case of a bank or bond insurer, or a special-purpose entity created simply to issue CDOs or SIVs.

The lack of foundation for the differential rating standards applied to corporate and municipal issuers has been demonstrated by your agencies' own default studies. Municipal bonds rated Baa by Moody's have had a default rate of only 0.13%, while corporate bonds rated Aaa by Moody's have defaulted at four times that rate, or 0.52%. Corporate bonds rated AAA by S&P have defaulted at almost twice the rate of municipal bonds rated BBB (0.60% and 0.32%, respectively).

We do not advocate that all municipal bonds should be rated triple-A. Certainly some deserve lower ratings, based on their unique circumstances. But bonds with an exceedingly low risk of default should be rated accordingly, whether issued by governmental entities or corporations. If some investors want fine rating distinctions among such bonds, perhaps gradations within the triple-A scale could serve that purpose. Some bonds could be Aaa1 or AAA+, while others could be Aaa3 or AAA-. But the triple-A rating on all those bonds would tell investors the truth: The risk of default is minimal.

We applaud some agencies' growing acknowledgement of the dual scale that exists today. Moody's, for example, will assign a "global scale rating," but only to taxable bonds. It simultaneously requires the assignment of a municipal scale rating. When the State of Oregon in 2003 sold \$2.1 billion in taxable general obligation bonds to fund its pension liabilities, Moody's assigned two ratings to the same bonds: Aaa global scale and Aa3 municipal scale. Similarly, when California sold taxable general obligation bonds in 2007, Moody's assigned ratings of "Aaa" global scale and "A1" municipal scale. These distinctions reflected both states' substantial credit strength compared to most corporate issuers, and helped attract new buyers for the taxable bonds. But they also created confusion because the very same bonds carried two different ratings. Such confusion does not serve investors well. Investors increasingly function in a worldwide capital market where the trading of credit risk is not isolated to distinct taxable and tax-exempt cash markets. Municipal credits are compared to corporate credits in a great number of markets, including the interest rate swap and credit default markets. An integrated, global capital market requires an integrated, global rating scale.

This dual rating scale burdens taxpayers and ratepayers with substantial, added costs. Taxpayers pay a higher interest rate when municipal bonds have a rating lower than triple-A. Consider, for example, the State of California, which never has defaulted on its bonds and ranks as the largest municipal issuer in the nation. The difference between triple-A and single-A interest rates in today's market is about 0.38 percentage points.<sup>1</sup> California plans to issue \$61 billion of general obligation bonds for infrastructure projects already approved by voters. Over the 30-year life of those bonds, a 0.38% difference in interest rates would save taxpayers, and the state's General Fund, more than \$5 billion. While a sudden recalibration of your agencies' rating scale likely would not produce the full amount of those savings, even a portion would provide welcome relief to California taxpayers. Similar examples abound in states, cities and counties throughout the country, resulting in hundreds of billions of dollars in unnecessary costs to American taxpayers.

Taxpayers incur other costs imposed by the bond insurance industry, which exists in large part because of your municipal rating scales. Municipal issuers have paid enormous sums to buy bond insurance that – at least in the past – brought their ratings up to the level they would have been on a corporate, or global, rating scale. For example, the State of California, with a global scale rating from Moody's of Aaa, nonetheless paid \$102 million from 2003-07 to buy triple-A bond insurance on its general obligation bonds. Those purchases allowed the state to sell the bonds at a lower interest rate. But it would have been unnecessary to spend \$102 million of taxpayers' money for a triple-A rating if the bonds had been rated by the same criteria as non-municipal debt.

Further, what California actually bought when it paid for bond insurance was not a triple-A municipal rating, but a triple-A global scale rating. Moody's has stated, "Like other financial institutions and insurance companies, the financial guarantors are rated on the global scale." (*Mapping of Moody's Municipal Ratings to the Global Scale: Frequently Asked Questions*, June 2007). Now consider: As noted above, Moody's gave a triple-A global scale rating to taxable bonds California issued in 2007. Applying that rating to all general obligation bonds the state insured from 2003-07, including tax-exempt issues, means that when taxpayers spent \$102 million to insure those bonds, they effectively spent \$102 million to put an Aaa rating on top of the Aaa rating the state already possessed.

The recent problems of municipal bond insurers, ignited by their exposure to securities based on sub-prime mortgages, have imposed serious, additional costs on numerous municipal issuers. The short-term municipal bond market has been built on the triple-A status of bond insurers. In part, the insurers' ratings have been used to satisfy regulatory requirements. But over time, the homogenizing nature of a market based on triple-A ratings meant that even issuers whose debt could be issued without bond insurance frequently found it useful to purchase insurance.

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<sup>1</sup> Municipal Market Data yield differential between Aaa/AAA and A/A 30 year bonds as of February 25, 2008.

Mr. Belsky, Ms. Sussman, and Mr. Montrone  
March 4, 2008  
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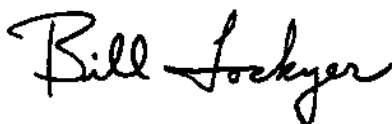
Under U.S. Securities and Exchange Commission Rule 2a-7, money market funds generally are allowed to buy securities only if they have long-term ratings of at least double-A. To provide that, many municipal issuers purchased bond insurance on their variable rate demand bonds (VRDBs). Of course, this would not have been necessary if municipal issuers were rated on a corporate scale. Corporations of much weaker credit quality comply with Rule 2a-7 without credit enhancement such as bond insurance.

The current turmoil in the tax-exempt variable rate market was sparked by the rating agencies' reassessment or downgrading of bond insurers. The agencies' actions caused many investors to worry that the insurers' ratings may drop below 2a-7's required levels. Already, insurer-backed VRDBs are costing much more than in the past. More troublesome, the liquidity facilities guaranteeing the demand feature of VRDBs can drop away if the bond insurer faces difficulties, at a time when the banks that remarket the bonds are facing their own sub-prime induced balance sheet problems. As a result, many issuers of VRDBs are finding that remarketing agents are putting their bonds to the liquidity banks, which in turn require issuers to pay them high taxable rates specified in the bond documents.

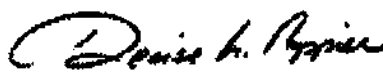
The fallout from the bond insurance upheaval also has hit the auction rate securities (ARS) market. Rating agencies' downgrades or reassessments of insurers – and the possibility of further downgrades in the future – have driven away many of the typical ARS buyers, including corporate money managers and wealthy individuals. Corporate money managers often have minimum rating requirements for the bonds they own. They relied on bond insurance for such ratings, since the underlying securities carried lower ratings assigned on a municipal rating scale. The well-publicized problems of failed auctions caused by insurer downgrades are imposing substantial costs on municipalities. Many issuers have found themselves paying interest rates as high as 15%-20% on debt that cost a fraction of that amount just a few weeks earlier.

We believe you share our desire to strengthen the municipal bond market that funds the infrastructure necessary to secure America's future. We respectfully request that you work with market participants – including issuers and investors – to develop a new, unified global rating approach that achieves that goal, and better serves investors and taxpayers.

Thank you.



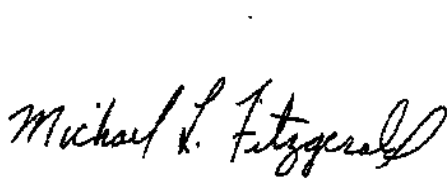
Bill Lockyer  
State Treasurer, California



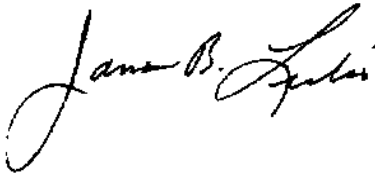
Denise L. Nappier  
State Treasurer, Connecticut



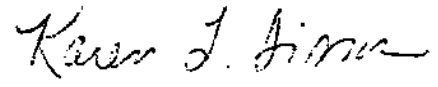
Ron G. Crane  
State Treasurer, Idaho



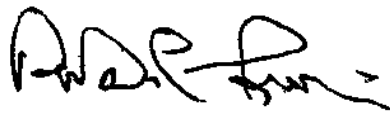
Michael L. Fitzgerald  
State Treasurer, Iowa



James B. Lewis,  
State Treasurer, New Mexico



Karen L. Sisson  
City Administrative Officer,  
City of Los Angeles



David G. Lemoine  
State Treasurer, Maine



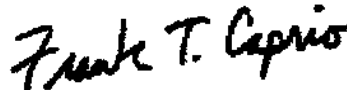
Randall Edwards  
State Treasurer, Oregon



Patrick Born  
Chief Financial Officer, City  
of Minneapolis



Kate Marshall  
State Treasurer, Nevada



Frank T. Caprio  
General Treasurer, Rhode  
Island



Roger L. Anderson  
Executive Director, New  
Jersey Educational Facilities  
Authority



R. David Rousseau  
Acting State Treasurer, New  
Jersey



Michael J. Murphy  
State Treasurer, Washington



Gary M. Breaux  
Director of Finance, East Bay  
Municipal Utility District



# NEWS RELEASE

CALIFORNIA STATE TREASURER BILL LOCKYER

FOR IMMEDIATE RELEASE  
March 4, 2007

Contact: Tom Dresslar  
916-653-2995

## **Treasurer Lockyer Urges Rating Agencies to Stop Holding Government Bond Issuers to Higher Standard than Companies** *Change Could Save State Budget Hundreds of Millions of Dollars*

SACRAMENTO – State Treasurer Bill Lockyer today urged the three major bond rating agencies to stop holding government issuers to a higher standard than corporations, saying a more equitable system could save California's state budget hundreds of millions of dollars.

"The rating agencies' dual standard makes no sense and does a lot of harm," said Lockyer. "The system misleads investors by providing inaccurate information about risk, and costs American taxpayers billions of dollars in higher interest rates and bond insurance premiums.

"The State of California never has defaulted on its bonds. State and local governments across the country default at a far lower rate than corporations. Yet, the dual standard imposed by these agencies unfairly taints California and other municipal bond issuers with lower credit ratings. We need a system that better reflects the actual credit risk, and better serves investors, taxpayers and the market."

Lockyer sent a letter to Standard & Poor's, Moody's Investors Services and Fitch Ratings urging the agencies to abandon the dual standard and rate municipal bonds based on the actual risk of default. Ten other State Treasurers and representatives of four other large municipal bond issuers also signed the letter.

California, which sold \$12.1 billion of general obligation bonds in 2007, is the largest municipal issuer in the nation. Lockyer wrote the letter and enlisted support from fellow Treasurers and other state and local public finance officials. Additional state and local municipal finance officers are expected to join the drive as the U.S. House of Representatives' Financial Services Committee gears up for a planned March 12 hearing on the municipal bond market. Lockyer also is seeking support from key institutional investors.

"We believe you share our desire to strengthen the municipal bond market that funds the infrastructure necessary to secure America's future," the letter states. "We respectfully request that you work with market participants – including issuers and investors – to develop a new rating approach that achieves that goal, and better serves investors and taxpayers."

(MORE)



Recent market upheavals caused by radioactive subprime mortgage debt instruments and the crisis in the bond insurance industry have inflicted collateral damage on municipal issuers that can be traced back to the dual rating standard, according to the letter.

To finance infrastructure projects already approved by California voters, Lockyer noted the State must issue \$61 billion in general obligation (GO) bonds. If those bonds received the triple-A rating Lockyer said they deserved, California taxpayers and the State's general fund could save up to \$5 billion in interest rates over the 30-year life of the bonds. That estimate is based on last week's 0.38 percent market differential between the interest paid on single-A bonds – California's current GO rating – and triple-A bonds.

“While a sudden recalibration of your agencies' rating scale likely would not produce the full amount of those savings, even a portion would provide welcome relief to California taxpayers,” the letter states. “Similar examples abound in states, cities and counties throughout the country, resulting in hundreds of billions of dollars in unnecessary costs to American taxpayers.”

Aside from Lockyer, the other initial signatories to the letter include: State Treasurers of Connecticut, Idaho, Iowa, Maine, Nevada, New Jersey, New Mexico, Oregon, Rhode Island and Washington; City of Minneapolis; City of Los Angeles; East Bay Municipal Utility District; and New Jersey Educational Facilities Authority. Additionally, the State Treasurer of Pennsylvania and the Chief Financial Officer of Florida agreed to endorse the letter in separate correspondence to the rating agencies.

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March 3, 2008

## States and Cities Start Rebelling on Bond Ratings

By JULIE CRESWELL and VIKAS BAJAJ

Does Wall Street underrate Main Street?

A growing number of states and cities say yes. If they are right, billions of taxpayers' dollars — money that could be used to build schools, pave roads and repair bridges — are being siphoned off in the financial markets, where the recent tumult has driven up borrowing costs for many communities.

A complex system of credit ratings and insurance policies that Wall Street uses to set prices for municipal bonds makes borrowing needlessly expensive for many localities, some officials say. States and cities have begun to fight back, saying they can no longer afford the status quo given the slackening economy and recent market turmoil.

Municipal bonds, often considered among the safest investments, sank along with stocks last week, darkening the already grim mood in the markets. Several big hedge funds unloaded bonds as banks further tightened credit to contain the damage from mounting losses on home mortgages and other loans.

States and cities rarely dishonor their debts. The bonds they sell to investors are generally tax-free and much safer than those issued by corporations. But some officials complain that ratings firms assign municipal borrowers low credit scores compared with corporations. Taxpayers ultimately pay the price, the officials say, in the form of higher fees and interest costs on public debt.

"Taxpayers are paying billions of dollars in increased costs because of the dual standard used by the rating bureaus," said Bill Lockyer, treasurer of California, who is leading a nationwide campaign to change the way the bonds are rated. California, one of the largest issuers of municipal bonds, is rated A; Mr. Lockyer said the state should be triple A.

The state is soliciting support from other municipalities for a letter it intends to send to the ratings agencies, arguing that municipal bonds should be rated on the same scale as the one used for corporate bonds.

Because of their relatively weak credit scores, more than half of all municipal borrowers buy insurance policies that safeguard their bonds in the unlikely event that they fail to pay the debt. California, for instance, paid \$102 million to insure more than \$9 billion in general obligation debt between 2003 and 2007.

Ratings agencies like Standard & Poor's, Moody's Investors Service and Fitch Ratings are paid a second time to evaluate the insured bonds.

Officials at ratings firms and bond insurance companies defend the system, saying it gives investors the information they need to buy bonds with confidence. The recent turmoil, they say, highlights the need for insurance. They further add that rating municipal bonds like corporate debt would not save taxpayers much money, if any.

The outcry in the municipal market comes at a difficult time for the ratings firms and bond insurers. S. & P., Moody's and Fitch Ratings have drawn criticism for assigning their highest grades to securities tied to subprime mortgages, only to downgrade them later as defaults surged and the investments tumbled in value.

The plunging fortunes of bond guarantors, meantime, have cast doubt over the value of the insurance policies municipalities buy.

"We are learning essentially that the emperor may have no clothes, that there is no real reason to require these towns to have insurance in many instances," said Richard Blumenthal, the attorney general of Connecticut, who is investigating the ratings firms on antitrust grounds. "And it simply serves the bottom lines of the ratings agencies, the insurers or both."

The House Financial Services Committee plans to examine how municipal bonds are rated at a hearing on March 12.

At every rating, municipal bonds default less often than similarly rated corporate bonds, according to Moody's. In fact, since 1970, A-rated municipal bonds have defaulted far less frequently than corporate bonds with top triple-A ratings. Furthermore, when municipalities do default, investors usually receive some — or even all — of their money back, unlike in most corporate bankruptcies.

But critics like Mr. Lockyer and Mr. Blumenthal face an uphill battle to change the Wall Street system. Upgrading municipal ratings would dramatically alter the landscape of the \$2.6 trillion market; Moody's estimates that more than half of the market would be rated triple A or double A using the corporate scale. Triple-A securities are considered nearly as safe as Treasury bonds

issued by the federal government.

Moreover, some bond specialists caution that this is the wrong time to rerate municipal bonds. The slowing economy and faltering housing market are squeezing state and city tax revenue. At the same time, public pension liabilities keep rising. Facing budget shortfalls, states like California, New Jersey and Arizona are cutting services.

Ratings firms, bond insurance companies and some bond investors defend the separate ratings scales, arguing that it allows investors to make distinctions among various debt and, ultimately, set appropriate interest rates. Defenders of the current system say that sophisticated investors understand that the letter grades assigned to corporate bonds and municipal debt mean different things.

Gail Sussman, the Moody's executive in charge of public finance ratings, likened the firm's dual ratings scale to a ruler that measures in inches on one side and centimeters on the other.

"The distance between point A and point B is the same" whether it is measured in inches or centimeters, Ms. Sussman said.

Moody's says it is willing to discuss changing its scale; so far few local and state officials have asked for a change, Ms. Sussman said. And when Moody's asked for comments on the issue several years ago, investors, bankers and insurers overwhelmingly favored the status quo, she said.

Executives at S.& P., however, say they use a single global rating scale to measure all kinds of debt. Colleen Woodell, chief quality officer for public finance, acknowledged that municipal debt had defaulted at lower rates than corporate issues, but she noted that the data covered a relatively benign 20-year period.

Ms. Woodell said the disparity was "within a tolerable band" and would diminish over time. She said the firm upgraded a number of municipalities after it finished its first default study in 2000. (Data on S.& P.-rated municipal and corporate debt from the early 1980s to 2006 show similar differences in default rates as those rated by Moody's.)

Some sophisticated bond investors say that if municipalities were rated on the same scale as corporations, it would be harder to distinguish the relative riskiness of various cities, states and school districts, and mutual fund companies would have to evaluate bonds issue by issue.

"If you rate 95 percent of the issues the same, the ratings cease to be useful, and investors need

and utilize these ratings to differentiate credits,” said John Miller, chief investment officer at Nuveen Asset Management in Chicago, which manages about \$65 billion in mostly tax-exempt bonds.

But local and state officials counter that a universal rating system would emphasize the relative safety of their debt against other bonds, arguably attracting more investors. In periods of stress like now more ready buyers would help reduce instability and help keep borrowing costs low.

So far, Mr. Lockyer has won support for his plan from half a dozen states, including Connecticut, Oregon and Washington, as well as from numerous cities and local authorities. They plan to send a letter to the three ratings agencies early this week calling for action.

Other public finance officials, including those for New York City, said that while they agreed municipal bonds were underrated, they would not sign the letter. New York City’s bond rating is double A.

The Government Finance Officers Association of the United States and Canada, which represents 17,200 local and state governments, is weighing whether it wants to take a stand on the issue before its annual conference in June.

The debate is not new. It has been pushed to the forefront because of the recent concern about the strength of bond insurance companies like MBIA and the Ambac Financial Group, which together guarantee interest and principal payments on \$733 billion in municipal debt.

The insurers are themselves rated triple A — on the corporate scale — by Moody’s and S.& P., and essentially transfer those gilt-edged ratings to municipal issuers through the policies they sell. Municipal issuers with lower ratings paid \$2.5 billion in premiums for bond insurance last year alone. In exchange, they typically pay lower interest rates on their debt than they would without the insurance.

Robert G. Shoback, a senior managing director of public finance at Ambac, said bond insurance lowered the cost of borrowing money, especially for smaller municipalities and school districts that might not be well known on Wall Street. Investors have relied on insurance for “comfort, confidence and stability,” he said.

But this year investors effectively stripped away the premium they placed on insured municipal bonds because they feared the bond insurers would lose their top ratings and, as a result, the bonds those companies insured would be downgraded, too.

“The industry is at a significant point now in how it views itself, how it interprets risk and how it will use insurance going forward,” said Thomas Doe, chief executive of Municipal Market Advisors, a research firm.

Mr. Blumenthal, the Connecticut attorney general, said the recent turmoil had allowed municipalities to voice long-held frustrations that they did not feel comfortable expressing earlier, fearful that ratings firms would refuse to rate them or give them low ratings.

The California group and other municipalities say there may be some middle ground where the two sides could compromise. Investors could still have finer delineations among bonds if rating agencies added suffixes to the newly triple-A-rated bonds, like Aaa1, Aaa2, and so on, said Roger L. Anderson, executive director for the New Jersey Education Facilities Authority, who has agreed to sign California’s letter.

Ms. Sussman, of Moody’s, said the firm would be wary about adding qualifiers to triple-A ratings, which the company regards as “gilt-edged.”

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**Bloomberg.com**

## California Calling for Changes in Ratings Systems (Update2)

By Adam L. Cataldo and Christine Richard

March 3 (Bloomberg) -- California, the biggest borrower in the U.S. municipal bond market, is leading a movement to change how \$2.6 trillion of state and local government bonds are rated.

Credit-rating companies should scrap municipal ratings that exaggerate the risk cities and states will default on their debts, California Treasurer **Bill Lockyer** will say in a letter to the firms later this month.

``It's unfair to issuers," said Paul Rosenstiel, debt manager for California, which plans to circulate the letter to public officials and collect additional signatures. ``It's unfair to taxpayers who then pay higher interest rates."

Many public borrowers, and every state except Louisiana, would be ranked AAA if measured by the same scale used for companies, reducing the need for insurance that backs about half of all state and local government debt. That insurance has been a liability in recent months as the guarantors' own ratings have been threatened by losses tied to rising subprime mortgage delinquencies, prompting investors to shun insured bonds and driving up municipal borrowing costs.

The letter is to be completed in time for hearings before the U.S. House Financial Services Committee. They are scheduled March 12, according to **Steven Adamske**, a committee spokesman.

### Insurer Impact

``The problems with the bond insurers, the downgrades of bond insurers and the impact that that has had raises issues about whether the ratings scale really is performing in the interest of the market," Rosenstiel said.

Two of the three major ratings companies said they will await the letter and will react accordingly.

``I am sure we will consider what they have to say when we see it," **Michael Belsky**, a group managing director for U.S. public finance at Fitch, said about the letter. ``We are open to comments and discussions from all market participants, investors, issuers."

Moody's will also continue speaking to people in the market to ``enhance the overall quality, transparency and usefulness" of ratings, **Gail Sussman**, a Moody's group managing director in public finance, said in an e-mail sent by a spokesman.

Standard & Poor's spokeswoman **Mimi Barker** declined to comment.

While corporations are assigned ratings based on the probability that investors will lose money on their securities, cities, states, hospitals, school districts and other local entities are ranked relative to one another and their fiscal health.

### Few Defaults

Only a few of the financially strongest municipal issuers garner top ratings, even though a corporation is about 97 times more likely than a municipal issuer to default on its debt over a 10-year period, according to Moody's data.

Because many individual investors prefer AAA-rated bonds and some mutual funds can only buy top-ranked securities, municipal borrowers often purchase a AAA rating from a bond insurance company.

The cost of rating municipal bonds on a different scale from other types of borrowers may have saddled U.S. taxpayers with as much as \$3.6 billion of extra interest payments on \$358 billion of bonds sold in 2006, according to **Matt Fabian**, an analyst at **Municipal Market Advisors**, a research firm in Concord, Massachusetts, and data compiled by Bloomberg.

The municipal bond market's reliance on insurance caused a surge in funding costs over the last several months as credit rating companies said they were reviewing whether the insurers still merited top ratings after backing bonds linked to subprime mortgages.

#### Ratings Pressure

MBIA Inc.'s AAA financial guarantee rating was affirmed by Moody's and S&P last week, though the outlook is negative.

The bond market will regain stability ``relatively quickly," said **Jay Brown**, MBIA's chief executive officer during an interview with Bloomberg Television today.

``At that point, we will stand ready to assist issuers as cheaply and efficiently as possible," said Brown, who returned to the company last month after departing as chairman last May.

Competitor Ambac Financial Group Inc. is trying to raise \$3 billion in capital to maintain its top insurance rating. FGIC Corp.'s bond insurance rating was cut six levels to A3 by Moody's, which said it may cut the ratings again.

``As issuers reconsider the value of insurance, we also want to make sure the market puts an appropriate value on state and local government credits," said Patrick Born, former debt committee chairman for the Government Finance Officer's Association. ``That is probably the reason why this issue, which has been simmering for quite a long time, has become a more widespread discussion among issuers."

#### Minneapolis Support

Born, chief financial officer for the city of Minneapolis, said he would sign the letter being drafted by California asking the credit-rating companies to reconsider their rating scale for municipal bonds.

Some members of Congress are also seeking to change the tax code to permit the **12 Federal Home Loan Banks** to expand the credit support they offer for tax-exempt bonds. The banks, which aid commercial lenders' home mortgage activity, currently sell credit enhancement for housing bonds. Legislation introduced last May would permit them to expand into other sectors of the municipal market.

Permitting the home loan banks to guarantee debt sold by municipalities, hospitals and schools ``will create a new source of credit enhancement and help fill a void created by the ongoing problems in the bond insurance industry," wrote **Paul Kanjorski**, a Pennsylvania Democrat and member of the House Financial Services Committee, in a Feb. 28 letter. It was addressed to the House Ways and Means Committee and signed by 41 House members.

#### 'Long Overdue'

Municipal borrowers have lower default rates and their ratings should reflect that strength, said Born, who headed the government finance association's debt committee from 2004 to 2007.

A change in rating company policy is ``long overdue" said Connecticut Attorney General **Richard Blumenthal**, who supports California's efforts. His office started an antitrust investigation about six months ago that will look at possible improper dealings between ratings companies and bond insurers.

The ratings companies and some insurers, including MBIA and Ambac, have turned over documents in response to subpoenas from Blumenthal's office, he said. All 169 municipalities in Connecticut were asked for information on how much they have spent on bond insurance. About one-third have responded so far, Blumenthal said.

``Essentially, municipal and state debt has been tremendously underestimated in terms of its security



and stability," Blumenthal said. ``Taxpayers in effect have been burning scarce dollars on insurance costs that are very avoidable."

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